Fiscal Issues on Decentralization in Kosovo

It is anticipated that decentralization would play an important role in maintaining stability and improving public service delivery in a multi-ethnic Kosovo. The basic foundation for carrying out decentralization in Kosovo was set by UN Security Council Resolution in 1999.\(^1\) When the UN Interim Administration Mission in Kosovo (UNMIK) took over the administration of Kosovo in 1999, it decided to create local government institutions before central institutions in order to build democracy from the ground up. In October 2002, the first municipal election was held, but only one-half of the population participated.

The current fiscal decentralization arrangement in Kosovo contains a number of good features, while there are a few weaknesses that the Kosovo authorities may wish to consider addressing. All of the 30 municipalities are of reasonable size. Their functions are prescribed in law and include primary education and primary health in addition to urban utilities, water supply, and street maintenance. These local functions are broadly compatible with main principles of decentralization.

Since their inception, local governments have played a critical role in service provision. While municipalities raise only about 4 percent of total budget revenue, they spend about 24 percent of total general government expenditure (largely financed through a system of transfers from the central government) and represent over 50 percent of total government employment. Municipalities are responsible for providing basic public services in the social sectors (primary and secondary education, primary healthcare, and some small social assistance programs), in infrastructure (such as local roads), and in public utilities (water and sewerage, and fire and emergency services).

The trend has been toward increased responsibilities for local governments. Over the past five years municipalities have become more prominent in public service delivery. However, they do not necessarily have more autonomy given their reliance on the center for fiscal transfers and their limited authority over the management of specific sectors. While there is an increasing budgetary role for municipalities in service provision, much of the policy and spending decisions are still taken at the central level.

As from 2005, 22.5 percent of the estimated central government revenue base goes to the municipalities. The grants are provided as a direct transfer to local government, without passing through the Education and Health Ministries. The transfer consists of three grants: education (48% of the total transfer in 2006), health (14%) and general administration (28%).\(^2\) These grants are calculated on the basis of formulas; in practice, their total is capped, so that actual allocations have been made on the basis of relative shares implied by the formulas. The criteria for the horizontal distribution of general, health, and education grants are straightforward, and since 2005 the actual distribution of transfers closely matches the formula-based distribution, indicating an improvement in transparency and predictability.

Figure 1: Structure of the Grant System, 2003-07

In terms of the transfers as a percent of total local government expenditure, the Kosovo municipalities stay on the high side by international standards as 80 percent.\(^3\) This trend, except for 2005, has remained broadly unchanged (see Table 1). In terms of international comparison, the 6 percent of GDP on average compares quite favorably with statistics in industrialized countries and is almost twice as much as in developing countries.\(^4\)

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Total expenditures by municipalities have declined slightly as a share of GDP since 2005. This was driven by lower capital spending and a decline in wages and salaries, as mandatory employment reductions at the municipal level took effect (see Table 2). Total local expenditure, including that from both grants and own source revenue falls on average, in terms of GDP, within the midrange with the Central European countries (excluding Social Protection and Public Order, which are the responsibility of central agencies in Kosovo). (see Tables 2). This may indicate that Kosovar local governments as a group account for a relatively small share of GDP compared to local governments in other Central European countries after the differences in expenditure responsibilities are taken into account. In addition, the World Bank comparative data suggest that the Kosovo education sector appears to be underfunded to some degree at the local level. However, this difference is offset by capital investments in primary and secondary schools financed by the Ministry of Education, Science and Technology (on average 0.5 percent of GDP) and channeled for the benefit of local government.

The system of municipal finances in Kosovo is conditioned predominantly on the revenue side and is combined with a recently introduced fiscal rule prescribing certain restrictions on the overall level of consolidated expenditure. This creates particular implications in terms of planning and management of relations between the central and municipal budget. The real growth of total budget expenditure, adhering to the Letter of Intent, is limited to no more than 0.5 percent. On the other hand, the total amount of the transfer to local government is pre-determined as 22.5 percent of total estimated revenue. These two rules are completely independent, as one is driven by expenditure and the other by revenue estimates. This means that if total revenue growth should be faster than an expenditure growth of 0.5 percent, more revenue would be allocated to municipalities while the total expenditure envelope would remain intact, which would push down the amount for central government. This situation is considered likely to occur in the future as the result of a deflationary environment and a projected revenue growth due to economic growth and improvements in tax administration.

Regarding vertical sharing, there appears to be a need to review and adjust the relative shares of expenditure between the two tiers of government to avoid unfunded mandates. The currently insufficient resource allocation to local education and health expenditures and the changes in local competencies according to the draft law on local government are two main reasons for this consideration. The total amounts to be allocated to education and health are determined through budgetary negotiations and have been consistently less than the amounts calculated by the transfer formulas, forcing municipalities to subsidize these costs from general revenues. While there is no evidence that municipalities as a whole are under-funded, there exists some risk that the central government may be increasingly imposing rising education and health spending obligations on municipalities without a corresponding increase in revenue.

There are a number of competencies that remain to be transferred to municipalities and this should be reflected in revenue sharing formulas. There are certain local functions that central government has undertaken until now and

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**Table 1: Municipal Dependency on Transfers, 2003-06**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Municipal Expenditure, in million euros</th>
<th>Nominal Growth (y-on-y), in %</th>
<th>Total Municipal Transfers, in million euros</th>
<th>Nominal Growth (y-on-y), in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>130.6</td>
<td>33.0</td>
<td>113.9</td>
<td>24.4</td>
</tr>
<tr>
<td>2004</td>
<td>173.8</td>
<td>-5.4</td>
<td>141.8</td>
<td>-10.6</td>
</tr>
<tr>
<td>2005</td>
<td>164.5</td>
<td>-0.5</td>
<td>126.8</td>
<td>4.7</td>
</tr>
<tr>
<td>2006</td>
<td>163.7</td>
<td>-0.5</td>
<td>132.8</td>
<td>4.7</td>
</tr>
</tbody>
</table>

**Table 2: Government and Municipal Expenditures, 2004-2007**

<table>
<thead>
<tr>
<th>Year</th>
<th>Municipal Total Expenditure</th>
<th>Wages and Salaries</th>
<th>Goods and Services</th>
<th>Subsidies and Transfers</th>
<th>Capital Outlays</th>
<th>Memorandum Items (in millions euros)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>100.0</td>
<td>60.3</td>
<td>18.7</td>
<td>0.1</td>
<td>20.9</td>
<td>749.0</td>
</tr>
<tr>
<td>2005</td>
<td>100.0</td>
<td>61.1</td>
<td>17.9</td>
<td>0.9</td>
<td>23.6</td>
<td>698.0</td>
</tr>
<tr>
<td>2006</td>
<td>100.0</td>
<td>61.2</td>
<td>18.0</td>
<td>1.6</td>
<td>19.5</td>
<td>630.0</td>
</tr>
<tr>
<td>2007</td>
<td>100.0</td>
<td>61.2</td>
<td>18.0</td>
<td>1.6</td>
<td>19.5</td>
<td>718.1</td>
</tr>
</tbody>
</table>

**Table 3: Selected Vertical Sharing Indicators – Total Local Expenditure as % of GDP, 2003-06**

<table>
<thead>
<tr>
<th>Category</th>
<th>Total</th>
<th>Total, excluding Social Protection and Public Order</th>
<th>Total Excluding Social Protection, Public Order, and Education</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kosovo Average 2003-2006</td>
<td>7.1</td>
<td>7.1</td>
<td>3.8</td>
</tr>
<tr>
<td>CEE Average</td>
<td>8.0</td>
<td>7.2</td>
<td>4.3</td>
</tr>
</tbody>
</table>

Source: Kosovo figures: MFE, Treasury Department Reports; International figures: World Bank
other functions that need to be transferred to municipalities. The transfer system should reflect such changes. It is suggested that the data on past budgetary expenditure allocations by function be used as a basis for adjusting vertical sharing between the two tiers of government. The normative bottom-up assessment of expenditure needs is very difficult to implement in practice and is likely to be fiscally unaffordable.

In addition, the unique situation of Kosovo may justify a temporary measure that would mitigate the unintended effect of the central government budget becoming residual. The current combination of a ceiling on overall expenditure growth and a revenue-based vertical sharing formula has made the central government budget absorb all of the uncertainty arising from macroeconomic fluctuations; if central government revenues increase faster than expenditures, the resources available to local government will consume an increasing proportion of the overall budget. As this could have a negative impact on service delivery both at the central and local levels, a temporary measure to mitigate this situation seems worth pursuing. The recent initiative by the MFE to peg the level of the grant to central government expenditure is a step in this direction.

In the long run, however, a revenue-based sharing formula is more desirable for mitigating potential macroeconomic fluctuations. It is important to recognize the potential danger of an expenditure-based vertical sharing formula. In particular, in a case in which actual revenue collection falls short of the planned expenditure, this formula could run into fiscal deficit, as municipalities would still request their fixed share of expenditure. The revenue-based formula would shift a reasonable share of the risk of revenue fluctuations onto municipal governments without tying them to the central government’s decision concerning its own level of spending.

Regarding horizontal sharing, the current distribution formula is assessed as being to a large extent transparent, simple, and equitable. Some fine-tuning of the education and health sectors indicators would nevertheless be desirable. The current formulas, which are based largely on population and a few norms in the education sector, are deemed appropriate given the lack of the accurate data that would be necessary for more advanced formulas. The data also shows a high degree of uniformity among municipalities in the level of per capita resources. This is largely because the education grant and the general grant, which are distributed largely on a per capita basis, form the largest share of total municipal revenues while the share of own revenues is rather insignificant.

For the education grant, the total amount has been less than the formula-based amount because of the overall ceiling on education expenditures, and this imposes risks of creating unfunded mandates in education. As education is considered as a high priority by the Government, increasing the total size of the education grant seems appropriate as long as the increase is within a fiscally affordable level. In addition, certain changes in the existing funding formula for the education grants bear consideration. In particular, the present formula fails to recognize the wide differences in costs and staffing requirements for teachers and other recurrent costs between urban and rural schools. It is recommended considering the different expenditure needs of rural and urban schools and including minimum standards (e.g., amount) for teaching materials per student to ensure the good quality of teaching and learning in classroom across Kosovo.

For the health grant, the current population based per capita formula should be updated to reflect international standards. Accordingly, the capitation formula should be based on the number of individuals registered with a Public Primary Health Care provider, and eventually should be risk-adjusted, at least by age and gender, to account for differences in the severity of case-mix across providers. To limit adverse responses to the financial incentives set by capitation, the quality and efficiency of the care delivery should be monitored and evaluated at the provider level, and the capitation payment should be expanded to reward quality compliance. Adapting the current status to international standards and implementing these changes would require a provider/purchaser split, aligning financial and management authority at the provider level and thereby making it possible for providers to react to capitation payment by adjusting their input factors (staff, etc.) to improve efficiency. This will require inter alia, additional investment in data collection and monitoring and evaluation capacity.

It is recommended that municipal capital expenditure should remain outside of the intergovernmental transfer system. In view of the on-and-off nature of capital expenditure, to include it in the intergovernmental transfers would seem inappropriate. Some of the large capital projects reflect national interests rather than local preferences and therefore need to be decided at the central level. The planned preparation of a health investment master plan is a good example of central level planning for municipal level capital projects which reflects a national interest.

On the other hand, giving greater managerial autonomy to municipalities and service providers which have proper internal control and reporting mechanisms could improve effectiveness and efficiency. There is an urgent need to improve managerial efficiency for municipal level capital projects, which are currently managed by the central government. Capital projects reflecting local preferences may be better managed by municipalities or even by service...
providers, as they are closer to the service users and thus have greater incentives. The ongoing certification process of
public internal financial control (PIFC) for municipalities could be used to identify municipalities that are “qualified” to
manage their own capital projects. This also implies that the central government needs to improve project preparation
and management skills.

Possible modifications in the intergovernmental transfer system, designed to give greater autonomy to municipalities, are also being considered. One of the major envisaged changes would to combine the education, health, and general revenue grant into a single block grant which municipalities could use as they see fit. Under such an arrangement, the central government’s scope for interfering in the local budget process would be limited to ensuring that procedures are correctly followed. This would have a significant impact on the relations between the central government and municipalities. On the positive side, this might contribute to more effective municipal resource allocation and improved service delivery. On the negative side, it would remove the two instruments that the Government now uses to ensure that sufficient funds are provided to the health and education sectors.

There are several possible solutions to this problem. One would be to insert some form of earmarking into the budget preparation guidelines and or the MOF budget review process requiring a minimum level of spending on the two sectors. A second would be to require a minimum level of standards for education and health by exercising the Government’s authority to regulate these two sectors. The difficulty with this approach lies in enforcing such standards. It would be counterproductive to systematically deny funds to an under-performing school or health care facility, particularly when its performance is the result of factors beyond its control. Nor is it clear when and how such regulations would be applied, given that most schools and health care facilities presumably do not meet the standards at the present time. A third solution would be to proceed with the block grant approach, with the expectation that the combined pressure from parents (of students), patients (of PHCs) and public employee unions (of teachers and health workers) would prevent municipalities from making any wholesale cuts in these two sectors.

Regarding the institutional arrangements, the current Treasury control system should remain unchanged. The Kosovo authorities have managed to build a fairly effective and strong Treasury control system that links central ministries and municipalities with the FreeBalance-based system. The disbursement process does not cause major delays in payment, and municipalities’ spending information is available in a timely manner. The transfer of competencies and resources to municipalities should not weaken this control mechanism.

Finally, there is an urgent need to improve both effectiveness and accountability between municipalities and service providers such as schools and primary healthcare centers. Today, municipalities allocate grant resources (from the education and health grant) to schools and PHCs without using objective and transparent criteria. As a result, these facilities do not know in advance the level of resources that they can expect to receive. This lack of predictability has undermined service providers’ ability to plan and manage service delivery in a more efficient manner. In this regard, it is instructive that the Pre-University Education Strategy 07-17 proposes decentralizing the management of the education grant. The same is needed for the health sector, to lead the delegation of financial and operational responsibility and accountability to the health facility level. In the same way, it is positive that the Municipal Budget Department of the MFE plans to gradually delegate budgetary decisions to the level of service providers. However, this implies that an appropriate legal and regulatory framework, as well as a monitoring and evaluation system, needs to be in place, while schools and primary health providers have an urgent need to build capacity in budgetary planning, financial management, and public procurement.

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1 UN Security Council Resolution 1244/99, Articles 10 and 11, and UNMIK Regulation no. 2001/9 on Constitutional Framework for Provisional Self-Government in Kosovo, Chapters 1,2,4,5,8 and 12.
2 For the 2007 budget, the Government has temporarily changed the basis of vertical sharing from revenue to expenditure to address the problem of previous formula, which makes central budget residual, moving in the opposite direction to the overall revenue growth trend.
3 However, it is important to recognize that international comparisons of transfer dependence need cautious interpretation unless differences in functional responsibilities are controlled. For example, teachers’ salaries are almost always financed from transfers.
4 It is worth noting that differences in vertical share across countries may be explained by a different degree of decentralization of expenditure responsibilities and revenue raising powers.
5 For the period 2006-07 a growth limit was applied to total budget expenditure. Following an agreement reached with the IMF, the growth restriction will apply to total primary current expenditure starting from the 2008-10 budget planning.
6 The next phase of decentralization, which is currently under preparation, is envisaged to grant municipalities some additional functions as well as increased fiscal autonomy. The envisaged changes are largely inspired by the Status Settlement Proposal (SSP), submitted by United Nations Special Envoy for Kosovo Martti Ahtisaari to the UN Security Council in March 2007, which foresees further decentralization.